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CHRIS MCCONNELL & ASSOCIATES

Disclosure May Be Lurking At LEN, So What's the BFD?

Chris McConnell, principal of Chris McConnell & Associates, an Accredited Investment Fiduciary Analyst (AIFA) in Los Angeles, California, has identified a case study in the making that continues to move his investigation and analysis of current issues involving breach of fiduciary duty (BFD) forward. A potential bad "Land" bank problem has been lurking beneath the surface at Lennar Corp (NYSE:LEN) for years. This may raise the specter of BFD for executives at LEN. Hundreds of off balance sheet, joint ventures hold various interests in land assets and related debt obligations. This allowed for a more favorable financial presentation but is reminiscent of the Enron era.

As a result, a potential quintuple conflict-laden fiduciary liability scenario arises. Is LEN a full-fledged five-flavor case study of BFD, a financial crime, a Cinderella story, or the saga of a recovering homebuilder in the making?

In an arrangement with the Fraud Discovery Institute (FDI), McConnell has been asked to help dissect the admittedly complex implications of the LEN case for shareholders, bondholders, other stakeholders and fiduciaries. He believes, based on the information and advice he has gathered following a 2008 10-k review, that (NYSE:LEN) is currently in compliance with GAAP, loan covenants and other regulations. However, compliance may be described as minimal and perhaps less than shareholder friendly. It is hoped that LEN soon returns to prosperity for the benefit of all, including the unconsolidated joint venture partners.

Five flavors of fiduciary responsibility: wearing more than one fiduciary hat leads to potential conflicts.

LEN executives and directors may jointly and severally owe a mélange of prudent fiduciary duty not limited to the following parties:

1) Shareholders, 2) employees – is it still prudent to own LEN shares in their 401k plan? – potential conflict with other shareholders, 3) joint venture partners – potential conflict with shareholders, 4) bondholders -- especially later if in the zone of insolvency, 5) to the beneficiaries of their own family trusts or foundations which own LEN shares – again potential conflict with shareholders.

What should a fiduciary do? Eliminate or manage around conflicts, second, fiduciaries depend on disclosure. Fiduciary duty is the highest standard known under the law. It is predicated upon trust; a fiduciary must place his own interests in second place, behind those of the principal. This is referred to as the duty of loyalty; other duties are care, skill, impartiality and caution with assets and any other requirement per the contract or instrument.

What intrigued McConnell about LEN is that it operates in many facets of what's ailing the US economy right now, notably homebuilding and credit. They served many first time and move-up homebuyers in the over 55 adult communities, following its acquisition of US Home, Inc. earlier this decade. LEN determined early on that land acquisition was a key industry profit driver. With a lead over its competitors, LEN obtained control of over 300,000 future lots – for instance, El Toro Marine Base in Orange County, CA and Newhall Land in the Santa Clarita Valley, CA. LEN's profits grew due to ventures like these, often held in off balance sheet entities, many with joint venture partners. An aggrieved Joint Venture partner has engaged FDI to investigate potential fraud at LEN.

Performance attribution is a key to dissecting past results and future insights into stocks. What is LEN? What “drove” its profits like few others in the boom years?

For many banks, broker/dealers, hedge funds, and other public companies, including Enron and Worldcom, which seemed to magically outperform rivals quarter after quarter, problems like off balance sheet entities, leverage (debt), aggressive if not questionable capitalizations and revenue recognition concerns

waited. Similarly, questions about the quality of earnings were pervasive. We've seen this scenario before, perhaps not yet at LEN, but we recognize an emerging pattern.

LEN is a two-sided coin: Side one shows that since year end 2006 over \$4 Billion or nearly 40% in write-downs on a \$12 Billion asset base have been recorded. Side two is a cloudy picture of uncertainty, revolving around asset values and liabilities; perhaps future write downs to come. Only LEN executives know the solutions; surely they realize their fiduciary duty to maximize shareholder value and yet these concerns have been floating around for several years now.

Additionally some analysts' concerns include:

- Accounting treatment erodes the quality of earnings; perhaps with cost and expense shifting to off balance sheet entities
- LEN has been able to increase debt and leverage in some joint ventures, in turn allowed it to take cash out; however, in a declining real estate environment may be imprudent.
- LEN has experienced increased leverage and financial risk off in the JV's while at the same time enhancing its own financial picture.
- Ironically, however, if LEN can reap \$100 million from a since terminated bankrupt JV, the man on the street may then ask why don't they look similarly to book gains from all the other joint ventures?
- Partnerships pay LEN a substantial amount in management fees, raises a potential conflict, control issues and or adequacy of reporting for related party transactions.
- With hundreds of millions in potential recourse exposure, shareholders are at risk of having a material amount of debt come onto (a shrinking) balance sheet. However, if LEN is able to go after other partners for up to two hundred million dollars of it, is this realistically recoverable given this industry environment?
- In the early boom years, gross margins from land sales have varied widely from about 1% to 36%; earnings from land development ranged from 9% to 20%.
- What's remains fenced off in the joint ventures for now potentially complicates and may stretch compliance with its lenders' recently tightened financial terms.

Valuation models used during the boom years triggered huge bonus checks, LEN's CEO earned over \$40 million in cash compensation (and owns 190,000 shares, with no purchases since 2007). According to McConnell, "No one that I know of at any financial services or real estate entity ever raised his or her hand upon receiving a bonus check during the boom years and said, "It's too much." Similarly, LEN will face continuing scrutiny in its future reporting of net realizable values of unsold homes and land that use off balance sheet or joint ventures with leverage and or recourse. LEN and its auditors Deloitte & Touche must recognize, although it's not currently required, that more transparent disclosures in the full light of day is the disinfectant that's needed; otherwise, bloggers (and others) may inquire.

Issues for fiduciaries – trustees, investment advisers, mutual funds and regulators and public policy makers include:

- Corporate governance rating of 26.4% or "D"
- CEO's family controls 47% of voting power
- Unconsolidated joint ventures, and ongoing questions of reporting transparency
- Warranty reserves dropped by \$35 million; in the context of LEN's lawsuit filed against a Chinese supplier and pending consumer complaints
- CEO cash compensation versus shares owned, scant insider holdings
- The impact of the Graham Leach Bliley Act and the role of financial intermediaries or disintermediaries

It's sometimes helpful to check out how an entity holds itself out to its customers and McConnell notes that LEN's sales pitch to would-be homebuyers states: "Everything's included"®, including the tag lines "Everything you want"... "Everything you need....we included it, look for the 'crystal clear' box at our Welcome Home Center"... Really? There appears to be a not-too-subtle contrast here to investors' uncertainty related to off balance sheet assets and liabilities NOT in its financial statements. Financial disclosures, like these tag lines, are clearly under management control; curiously for the time being, fuller disclosure is a problem--and remains in the shadows.

As McConnell noted in previous Fiduciary Alerts, “In good times, leverage can generate outsize, stellar profits. However, absent appropriate due diligence, in difficult times, astounding but avoidable losses will likely occur.”

About Chris McConnell, AIFA®

Chris McConnell received a BA in Economics with an Accounting option from Rutgers University in 1983, passed the CPA exam for New York State in 1986, and received an MBA from Pepperdine University in 1990. He was certified as an AIFA® by the Center for Fiduciary Studies in 2003. He has 25 years of combined experience as a recognized fiduciary and compensation expert, in addition to his considerable securities industry experience.

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